No. 20841

In the

# United States Court of Appeals

*For the Ninth Circuit*

---

DESERT DIET DEVELOPMENT CORP.,
*Appellant,*

vs.

CHARLES W. HERBERT, WALTER T. MOLL, and MELVIN HELLWITZ,
*Appellees.*

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## Appellees' Brief

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### INTRODUCTION

References to the Transcript of Record are indicated as "TR" with appropriate volume indicated.

We do not believe that Appellant has made any effort to comply with Rule 18(d) with respect to specification of errors. From the tenor of the argument advanced by Appellant, it appears that Appellant quarrels with Findings 13 and 14 and Conclusions 3 and 4 of the Special Master adopted by the Court.

Appellant filed objections to Findings 13 and 14 but did not make specific objection to Conclusions 3 and 4. Specification of error No. 1 is a false statement as we shall point out. That portion of Appellant's Specification of Errors set

forth following (2) we do not believe to be any specification of error whatsoever.

## SUPPLEMENTAL STATEMENT OF FACTS

Appellees desire to suggest some clarification and amendment to the facts as stated by Appellant.

The mortgage referred to on page 4 of Appellant's Brief, covering virtually all of the corporate property, secured a note to the First Commercial Bank of Chicago. The note and mortgage were assigned by the bank to Harold F. Schwartz. Following the institution of legal proceedings to foreclose the mortgage, the mortgage was purchased by a voluntary group from Mr. Schwartz on or about December 3, 1963. See Exhibit 21 and TR v. 3, pp. 55-57, for details of this transaction. Appellant's Brief is misleading in referring to this group of persons as a syndicate since throughout the record the term "syndicate investors" has been used to describe those who entered into contracts similar to Exhibits 4 and 6. The legal title to the note and mortgage is held by Stewart Title & Trust of Tucson as trustee for a group of co-owners who own in proportion to their contribution. The statement that there are three stockholders in the corporation is not supported by any evidence in the case. This allegation is made in the answer of the debtor, but no evidence whatsoever was offered in this regard and the stock record of the company was not produced. See Finding 9 of the Special Master, TR v. 1, p. 47. Counsel has departed from the record to state that the deed which was filed with the Clerk of the Court (not with the trustee) was a conveyance to all land purchasers. We now apologetically depart from the record to state to the Court categorically that this statement is not true. In the deed described, fifty-three of the lots were described with reference to unrecorded plats so that they have no effect whatsoever as con-

veyances. In addition, there are one hundred forty lot purchases fully paid up that have received nothing at all under the deed. The property of the corporation was abandoned by the management of the corporation and was cared for on a voluntary basis by syndicate investors. Real property taxes were delinquent for a period of about three years. Annual reports to the Arizona Corporation Commission were not made so the corporation was threatened with revocation of its charter. There is substantial evidence of misappropriation or misapplication of funds by management. Practically all of the assets of the corporation were permitted to suffer a foreclosure action which was forestalled by the voluntary action of interested parties. See Finding of Special Master No. 9, TR v. 1, p. 47.

## ANSWER TO ARGUMENT I

It is a complete answer to the Specifications of Error that Chapter XI relief is not available to Appellees.

Argument I consists in the main of directing the Court's attention to those cases involving a choice between Chapter X and Chapter XI as appropriate proceedings. Suffice it to say that the Court had no such choice in these proceedings since no Chapter XI petition was before the Court; and in view of the fact that the original petition in Chapter X was filed in July of 1965, it appears unlikely that one will ever be filed. If counsel wish to argue to the Court that Chapter XI proceedings were or are available to the Appellees, counsel is attempting to mislead the Court. Chapter XI is available only upon the voluntary petition of the debtor.

The fact that the debtor has not, and evidently will not, seek relief under Chapter XI should, in and of itself, be enough to establish that Appellees cannot procure adequate relief except under Chapter X. This point is made by Professor Moore, 6 *Collier on Bankruptcy* (14th Edition) 1034.

We quote:

> One situation may prove troublesome. Chapter XI does not authorize creditors to initiate proceedings; only a voluntary proceeding by the debtor is authorized. Suppose then that the debtor corporation has taken no steps under Chapter XI. Does that fact, coupled with the creditors' inability to invoke Chapter XI show that so far as the petitioners are concerned, adequate relief is not obtainable under Chapter XI? We believe the answer is in the affirmative, but that it will rarely be presented in such a bald fashion.

We will agree with Professor Moore that such a situation should rarely arise, but we have such a situation here. We have here such a case in which the debtor corporation which is unable to meet its debts as they mature and is threatened with a foreclosure of its entire property, has failed, and evidently proposes to continue to fail, to seek any form of relief under the Bankruptcy Act.

In summary, the entire argument embodied in the Appellant's Brief under Argument I has no application herein. The Court does not have, nor has it ever had, an opportunity to make any selection between Chapter X and Chapter XI as appropriate remedies, and Chapter XI is not available to Appellees.

## ANSWER TO ARGUMENT II

Appellant seeks to perpetuate the confusion of some of the earlier casse by referring to Chapter X relief as "drastic" relief, consistently adverting to the fact that Appellant has only three stockholders (a fact totally unsupported in the record, except by allegation in the answer of the debtor corporation), and generally suggesting to the Court that Chapter X relief should be denied, summarizing in what they choose to refer to as the "particular circum-

stances" of the case on page 18 of Appellant's Brief. We will comment on this summary as follows. They state that the Court knows the corporation has three stockholders. If the Court has any such knowledge, it is unshared by counsel, as pointed out in the above fact statement. Appellant blithely ignores the rights of the syndicate owners as equity owners. The statement that the purchasers of real estate have received relief by delivery of a deed to the truste is unsupported in the record, and counsel depart from the record to make the statement, as pointed out in the above fact statement. The statement is not true.

Further, in suggesting that petitioners received complete relief by the deed, counsel for Appellant conveniently ignore that portion of the indebtednesses to petitioners as follows:

$200 for water paid by Hellwitz (Exhibit 18);
$400 for water paid by Moll (Exhibit 19);
$200 for water paid by Moll (Exhibit 20).

It is a gross misstatement to suggest, and counsel in summary appear to suggest, that the deed cured the rights of everybody except syndicate investors. Counsel overlooks the following:

Partial payment on lots, $23,540.50 (TR v. 3, pp. 42, 43);
MITC lots sold, $54,956.95 (TR v. 3, p. 45);
Deposits on houses to be built, including furniture deposits, $77,830.67 (TR v. 3, p. 48);
Loans for the water company never built, $30,500.00 (TR v. 3, p. 51);
Deposits for water service never given, $7,535.67 (TR v. 3, p. 52);
"Short term" loans never repaid, $75,452.00 (TR v. 3, pp. 52, 53).

Next they suggest to the Court that syndicate investors have filed a suit in the state courts of Arizona. We suppose

that they mean to suggest that the declaratory judgment suit filed by some of the syndicate members in a class action gives full and adequate relief to the creditors. There is no specification of error whatsoever in connection with the finding of the Special Master and of the Court that this declaratory judgment suit did not afford adequate relief to the petitioners herein. Under Arizona law relief by way of a state court receivership is ancillary to the principal relief sought. *Ferguson v. Superior Court,* 76 Ariz. 31, 258 P.2d 421. We cannot believe that counsel seriously suggest to the Court that the pending action affords full relief to petitioners. There has been no specification of error sufficient to raise the point.

To get to the meat of the argument, we would suggest three points to the Court:

A. The record here establishes a clear case for Chapter X relief under the guide lines and criteria established by the United States Supreme Court.

B. The members of the syndicate herein are either *de facto* stockholders or equity owners in a class separate from the stockholders, whose rights require determination and adjustment, relief available only in a Chapter X proceeding.

C. Restating a point raised in connection with Argument I, the failure of the corporation to seek relief under Chapter XI in and of itself establishes Chapter X as the only adequate remedy available to petitioners.

We argue these points in order as follows:

A. The confusion in the earlier cases we believe largely attributable to the fact of a failure of understanding that in Chapter X a new remedy was established in the Bankruptcy Court for cases which theretofore could be handled only through the intricate mechanics of the old equity re-

ceivership and 77(b) of the Bankruptcy Act. Somehow some courts seemed to get the idea that it was available only where there was a large, publicly held corporation involved. What some of the early cases seemed to overlook was the fact that a Chapter XI court has the right only to effect a composition of the unsecured claims, and that if it became necessary to alter with the rights of secured creditors or to affect the interests of equity owners that Chapter X exclusively offers this relief. It seems to us that any confusion in this regard should have been put to rest for once and for all in the decision of the Supreme Court in *General Stores Corp. v. Shlensky* (1956), 350 U.S. 462, 76 S.Ct. 516, 100 L.Ed. 550, reaffirmed by a unanimous Supreme Court in *Securities and Exchange Commission v. American Trailer Rentals* (1965), 379 U.S. 594, 85 S.Ct. 513, 13 L.Ed.2d 510. There is an able discussion of the trend of the Supreme Court decisions at 6 *Collier on Bankruptcy* (14th Edition) pp. 841-846. As pointed out therein, the *Shlensky* case seemed to make it very clear that the choice of proceedings rests upon the feasibility of proceeding under either chapter without regard to the size or capital structure of the debtor. As we have pointed out above, the question of choice of proceedings is not before the Court, but certainly this case would seem to put at rest the argument that Chapter X is a "drastic" remedy as suggested by Appellant, or is limited only to corporations with largely held stock issues, which seems to be the innuendo throughout the Appellant's Brief. More important, we believe to be the criteria which have been set forth in the *Shlensky* case, supra (350 U.S. at 466, 76 S.Ct. at 519, 100 L.Ed. at 556), and the criteria which are suggested at 6 *Collier on Bankruptcy* (14th Edition) p. 845.

B. A point blithely ignored in Appellant's Brief is the allegation in the petition referred to in Finding 9 of the

Special Master, (TR v. 1, p. 47), with respect to the status of the syndicate investors. The form of syndicate contract is in the record as Exhibit 4. See also Exhibit 6. The case of *Reilly v. Clyne,* 27 Ariz. 432, 234 Pac. 35, decided by the Arizona Supreme Court, construing the Arizona Constitution, would seem to establish the syndicate investors in a class as *de facto* stockholders. This fact should give the reorganization court no trouble in the light of Section 106(3) of the Bankruptcy Act (11 U.S.C., Sec. 506(3)[1], which carries into Chapter X the broad definition of corporation embodied in Section 1(8) of the Bankruptcy Act (11 U.S.C., Sec. 1(8);[2] but regardless of whether the syndicate investors are *de facto* stockholders, on the face of the contract they are equity owners whose interests require determination and adjustment. As far as many and widespread investors are concerned, the original petition embodies the allegation, specifically admitted in the answer, that syndicate agreements were entered into with approximately 100 people throughout the United States with a total investment of about $300,000. See Finding 9 of the Special Master (TR v. 1, p. 47), to which there is no specification of error, and summary of syndicate investors embodied in Exhibit 8. Of particular interest are the criteria suggested at 6 *Collier on Bankruptcy* (14th Edition), p. 845, which the author suggests as factors of "extreme importance" in passing upon the desirability of Chapter X relief. Going through these in order, we suggest their applicability to this case as follows:

*Substantial Evidence of Misappropriation:*

The Court's attention is invited to Finding 10(d) of the Findings of the Special Master (TR v. 1, p. 48), to which

1. See Appendix B.
2. See Appendix B.

there is no specification of error, pointing out the fact that one Howard Inches, who appears to be an officer in the corporation, was paid a sum in excess of $195,000 from the period 1959 through 1963 on a personal account, the payments appearing to have been made for personal expenses, such as alimony, schooling for the children, unvouchered credit card expenses and the like.

Going to the next criterion suggested:

*Evidence of a Need for New Management:*

The Court's attention is invited to Finding 10 of the Special Master (TR 1, pp. 47-49), to which there is no specification of error, setting forth facts indicating either poor management or a total lack of management.

Proceeding to the next criterion suggested:

*The Evidence of a Need for a Thorough Examination by a Distinterested Trustee:*

We suggest to the Court a perusal of Finding 5 (TR v. 1, p. 46), Finding 9 (TR v. 1, p. 47), and Finding 10 (TR v. 1, pp. 47-49), to which there is no specification of error, pointing out the entire absence of any intelligent management whatsoever. We respectfully submit to the Court that the case at hand meets the criteria suggested by the Supreme Court, and we believe it to be most obvious that no other review is available. Even if Chapter XI relief were available to the Appellees, which it is not, we believe it too plain for argument that a composition of unsecured debt is no answer to these problems.

In the *Shlensky* (supra) case the Supreme Court pointed out (350 U.S. at 466, 76 S.Ct. at 519, 100 L.Ed. at 556) the following as "typical instances" where Chapter X provides the more adequate remedy:

> The character of the debtor is not the controlling consideration in a choice between c. X and c. XI. Nor is the nature of the capital structure. * * * The essential

> difference is not between the small company and the large company but between the needs to be served.
>
> Readjustment of all or a part of the debts of an insolvent company without sacrifice by the stockholders may violate the fundamental principle of a fair and equitable plan * * * as the United States Realty Co case emphasizes.
>
> Readjustment of the debt structure of a company without more may be inadequate unless there is also an accounting by the management for misdeeds which caused the debacle.
>
> Readjustment of the debts may be a minor problem compared with the need for new management. Without a new management today's readjustment may be a temporary moratorium before a major collapse.

The facts of this case bring it squarely within each one of these "typical instances."

C. We would like to reiterate the answer set forth to the Appellant's Argument I, calling attention of the Court to the fact that only Chapter X relief is available to these Appellees, who must proceed on an involuntary basis since the company refuses to do anything about its own problems.

We summarize the argument as follows:

1. There is no question before the Court as to any choice between Chapter X and Chapter XI. No Chapter XI petition has been filed, and Chapter XI relief is not available to these petitioners.

2. A simple composition of the unsecured debt would be grossly inadequate relief as far as other creditors, stockholders and investors are concerned.

3. The facts of this case bring it squarely within the criteria suggested by the text writers and by the Supreme Court of the United States as to the propriety and desirability of Chapter X relief.

## CONCLUSION

We suggest to the Court that this appeal is devoid of merit and that no right or interest of Appellant is being served by this appeal. We share the incredulity of the Special Master hearing the petition evidenced by his conversation with counsel for Appellant at the conclusion of the hearing:

> THE REFEREE: I'm curious, Mr. Van Slyke, when you answer for the corporation asking that the petition be dismissed, that the viedence (sic) here shows that it's been abandoned, no taxes have been paid, what does this corporation intend to do if it is dismissed?
>
> MR. VAN SLYKE: I'm not in a position to answer that, if the Court please.
>
> THE REFEREE: Well, it seems to me that somebody should be here in support of the petition to dismiss and state the reasons why.
>
> MR. VAN SLYKE: The Court might be right, but I'm not in a position to answer that or produce anyone.
>
> THE REFEREE: It would seem to me that this debtor corporation ought to be here trying to take advantage of some reorganization proceeding rather than let all its participating parties, their money go down the drain.
>
> I just don't understand the theory back of the contest by the debotr (sic). And you have no answer?
>
> MR. VAN SLYKE: I have no answer. (TR v. 3, p. 138, line 20 to p. 139, line 16)

We find no single case or authority cited in Appellant's Brief supporting its position as applied to this case. We are constrained to believe that the appeal has been interposed for delay in the interest of one or more individual stockholders who would rather see the company and its

> difference is not between the small company and the large company but between the needs to be served.
>
> Readjustment of all or a part of the debts of an insolvent company without sacrifice by the stockholders may violate the fundamental principle of a fair and equitable plan * * * as the United States Realty Co. case emphasizes.
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> Readjustment of the debt structure of a company without more may be inadequate unless there is also an accounting by the management for misdeeds which caused the debacle.
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We find no single case or authority cited in Appellant's Brief supporting its position as applied to this case. We are constrained to believe that the appeal has been interposed for delay in the interest of one or more individual stockholders who would rather see the company and its

creditors "go down the drain" than lose control. Certainly the Appellant-debtor is receiving no benefit by this appeal.

Respectfully submitted,

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*Attorney for Appellees*

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

CHARLES D. MCCARTY

**(Appendices Follow)**

## *Appendix A*

### INDEX TO EXHIBITS

Appellant has not complied with Rule 18 2 (f). Accordingly, for the convenience of the Court, the following is an index of the identification, offer and admission of the exhibits referred to in this brief. All page references are to TR v. 3.

| Exhibit | Identified | Offered | Received |
|---|---|---|---|
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| 6 | p. 23 | p. 23 | p. 24 |
| 8 | p. 28, 29 | p. 77 | p. 77 |
| 18 | p. 101 | p. 101 | p. 101 |
| 19 | p. 108 | p. 108 | p. 109 |
| 20 | p. 110 | p. 111 | p. 112 |
| 21 | p. 115 | p. 115 | p. 116 |

## *Appendix B*

### STATUTES CITED

Section 1(8) of the Bankruptcy Act [11 U.S.C. 1(8)].

1. *Meaning of words and phrases*

The words and phrases used in this title and in proceedings pursuant hereto shall, unless the same be inconsistent with the context, be construed as follows:

* * * (8) "Corporation" shall include all bodies having any of the powers and privileges of private corporations not possessed by individuals or partnerships and shall include partnership associations organized under laws making the capital subscribed alone responsible for the debts of the association, joint-stock companies, unincorporated companies and associations, and any business conducted by a trustee or trustees wherein beneficial interest or ownership is evidenced by certificate or other written instrument; * * *

Section 106(3) of the Bankruptcy Act [11 U.S.C. 506(3)]:

506. *In general*

For the purposes of this chapter, unless inconsistent with the context—

* * * (3) "corporation" shall mean a corporation, as defined in this title, which could be adjudged a bankrupt under this title, and any railroad corporation excepting a railroad corporation authorized to file a petition under section 205 of this title; * * *